REPORT OF EXAMINATION

CASCADE NATIONAL INSURANCE COMPANY

As of December 31, 1999

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify I have read the attached Report of the Financial Examination of the CASCADE NATIONAL INSURANCE COMPANY of Seattle, Washington. This report shows the financial condition and related corporate matters as of December 31, 1999.

____
Patrick McNaughton, Chief Examiner

CASCADE NATIONAL INSURANCE COMPANY

TABLE OF CONTENTS

Seattle, Washington
March 26, 2002

The Honorable Alfred W. Gross
Commissioner, Bureau of Insurance, Commonwealth of Virginia
Chair, NAIC Financial Condition (EX) Committee
PO Box 1157
Richmond, VA 23218

The Honorable Joel S. Ario
Insurance Administrator, Oregon Insurance Division
NAIC Secretary, Western Zone
350 Winter Street NE, Room 440
Salem, OR 97310-3883

The Honorable Mike Kreidler
Insurance Commissioner, State of Washington
PO Box 40255
Olympia, WA 98504-0255

Dear Commissioners:

In accordance with your instructions and in compliance with the statutes of the state of Washington, Chapter 48.03 Revised Code of Washington, an Association Examination has been made of the corporate affairs and financial records of the

CASCADE NATIONAL INSURANCE COMPANY
of
Seattle, Washington

hereinafter referred to as the Company, at its home office located at 2201 – 6th Avenue, Suite 1500, Seattle, Washington 98121. The following report on the examination is respectfully submitted showing the condition of the Company as of December 31, 1999.

SCOPE OF EXAMINATION

The first examination of the Company was a qualifying examination made as of December 23, 1994. The current examination conducted by insurance examiners from the state of Washington covered the period from December 24, 1994 through December 31, 1999. Additional examination procedures and testing were performed based upon subsequent events through September 30, 2001. The examination was conducted in accordance with the laws and regulations of the state of Washington contained in Title 48 of the Revised Code of Washington (RCW) and Title 284 of the Washington Administrative Code (WAC) and the examination procedures recommended by the National Association of Insurance Commissioners found in the NAIC Financial Condition Examiner's Handbook.

Corporate records and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. The Company’s Certified Public Accountant’s work papers were reviewed and utilized where possible to support efficiency in the examination.

INSTRUCTIONS

Pursuant to the findings and conclusions of the examiners and actuary, in accordance with sound actuarial principles, Title 48 RCW, Title 284 WAC and the NAIC Accounting Practices and Procedures Manual (APPM) for Property and Casualty Insurance Companies, the Company is hereby instructed to comply with the following:

1. **THE COMPANY IS INSTRUCTED** to comply with **RCW 48.05.280** and keep full and adequate accounts and records of its assets, obligations, transactions, and affairs.

   Reference “INFORMATION SYSTEMS AND ACCOUNTING RECORDS (pages 12 and 13)” regarding the premium database.

   Reference “EMPLOYEES’ BENEFIT PLANS (page 9)” regarding an IRS Determination Letter.

   Reference "SUBSEQUENT EVENTS (page 14)". The Company needs to develop written procedures and enhance the controls already in place to improve the flow of needed information between claim processing and underwriting performed by the general agents. Specifically, claims processing needs to have real time status of a policy when processing claims and general agents need to receive timely notice of claims which indicate the "at fault" person in order to accurately underwrite and rate the business it insures.

2. **THE COMPANY IS INSTRUCTED** to comply with **RCW 48.94.015** and obtain written authorization specifying the responsibilities of each party to the reinsurance transaction.

   Reference “REINSURANCE PROGRAM (page 11)” regarding the Broker Authorization Contract.

3. **THE COMPANY IS INSTRUCTED** to comply with **RCW 48.03.010** that requires adherence to the appropriate Annual Statement Instructions and the Accounting Practices, and Procedures Manuals promulgated by the NAIC for the completion of the annual statement.

   Reference “INTERNAL SECURITY (page 8)", Custodial Agreements” regarding the lack of custodial agreements and that securities brokers are not allowable custodians.

   Reference “INTERNAL SECURITY (page 8)", Fidelity Bond and Other Insurance” regarding the NAIC recommended level for fidelity insurance.

4. **THE COMPANY IS INSTRUCTED** to comply with **RCW 48.05.310(3)** and require its general agents to not allow producing agents who are licensed, but not appointed to bind an insurance risk.

   Reference, "SUBSEQUENT EVENTS (page 14)" regarding an examination finding that licensed, but not appointed producing agents were binding insurance risks in California.

COMMENTS AND RECOMMENDATIONS

Pursuant to the findings and conclusions of the examiners:

1. **IT IS RECOMMENDED** that future Holding Company filings include Kenneth I. Tobey and Allied Pacific Adjusting Group.

   Reference “ORGANIZATIONAL CHART (page 5)” and “NON-INSURANCE COMPANIES UNDER COMMON OWNERSHIP and MANAGEMENT (pages 4 and 13)” regarding disclosures required in Chapter 48.31B RCW.

2. **IT IS RECOMMENDED** that the title of the general agency agreements have the word “Managing” removed.

   Reference “AGREEMENTS, General Agency Agreements (page 8)" regarding the definition of a “Managing” general agent.

3. **IT IS RECOMMENDED** that the Company as cost effectively as possible, seek reimbursement on those claims paid on policies that were not in-force on the day of loss.

   Reference, "SUBSEQUENT EVENTS (page 14)" regarding an examination finding that claims were paid on policies that were not in-force.

HISTORY

CASCADE NATIONAL INSURANCE COMPANY (the Company) is a Washington corporation organized as a stock insurance company on December 20, 1994 when the Articles of Incorporation and Bylaws were filed. On the same day the Washington Insurance Commissioner issued a Solicitation Permit # 273, authorizing the sale of 300,000 shares of $10 par value common capital stock of the Company for a purchase price of $3,000,000. Pursuant to an escrow agreement, Clarendon National Insurance Company (Clarendon) purchased all shares. RCW 48.05.340 requires that a domestic stock insurance company maintain a minimum capital of $3,000,000 and paid-in surplus of $3,000,000 for a total capital and surplus of $6,000,000. Clarendon contributed $3,500,000 as paid in surplus to provide the Company with $500,000 working capital.

Clarendon and Harold L. Anderson (Anderson) entered into an option for the purchase of the Company in 1995. Anderson is the sole shareholder of Legend Holdings, Inc. (LHI). Anderson through LHI, purchased the Company for its capital and surplus as of June 30, 1998.

A stock purchase agreement was prepared as of June 30, 1998 among: Harold L. Anderson, an individual, Legend Holdings, Inc. (LHI), a Washington insurance holding company (Anderson and LHI referred to collectively as purchaser), and Clarendon National Insurance Company, (seller), a New Jersey insurance company. The agreement was executed August 12, 1998. Legend Holdings, Inc. (LHI) now wholly owns the Company.

CAPITALIZATION: The Company's Articles of Incorporation authorize the issuance of 600,000 shares $10 par value common capital stock. 300,000 shares are issued and outstanding. The Company has no preferred stock.

STOCKHOLDERS DIVIDEND DISTRIBUTIONS: The Company had sufficient earnings and earned surplus in the prior years to allow payment of a cash dividend. Based upon 1997 earnings, the Company distributed a cash dividend during 1998 in the amount of $950,000 to Clarendon in partial consideration of the Company's sale to Legend Holdings, Inc. The Company also distributed an ordinary cash dividend of $650,000 to LHI during 1999 based upon 1998 earnings. Proper notifications were given and approval obtained pursuant to RCW 48.08.030.

AFFILIATED COMPANY

LEGEND HOLDINGS INC. (LHI) is a financial service holding company organized in the State of Washington on June 26, 1998. Harold L. Anderson, an individual, wholly owns LHI.

NON-INSURANCE COMPANIES UNDER COMMON OWNERSHIP and MANAGEMENT

KENNETH I. TOBEY, INC. (KIT) is an insurance agency that is licensed and authorized to procure, underwrite and service automobile insurance on behalf of the Company. Harold L. Anderson, an individual, also wholly owns KIT.

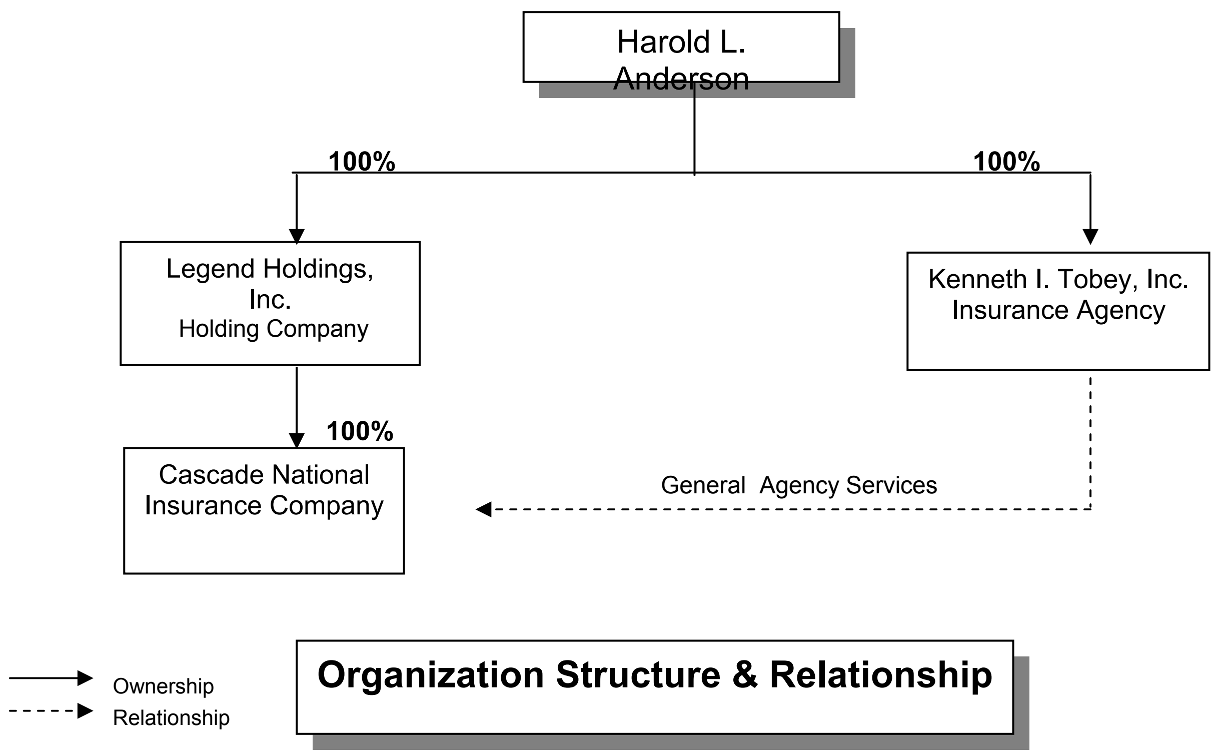
ALLIED PACIFIC ADJUSTING GROUP (APAG) administers the Company claims reporting and settlement process under direct, on site supervision by the Company VP of Claims. APAG was purchased during the year 2000 and is now also wholly owned by Harold L. Anderson, an individual.

Considering the 100% ownership and direct management control that Harold Anderson has over Kenneth I. Tobey, Allied Pacific Adjusting Group, Legend Holdings, and Cascade National

Insurance Company, Kenneth I Tobey and Allied Pacific Adjusting Group should be disclosed under the definitions of Chapter 48.31B RCW, Insurer Holding Company Act. **(see Comments and Recommendations # 1)**

ORGANIZATIONAL CHART

The following organization chart depicts the relationship of the affiliates under the COMPANY holding company system and other non-insurance companies under common management as of December 31, 1999.



MANAGEMENT and CONTROL

BOARD OF DIRECTORS:

Control of the Company is vested in the Board of Directors (BOD) consisting of four members as of December 31, 1999. The BOD is elected at the annual stockholders meeting for a one-year term. The BOD was composed of between four and seven members throughout the period of examination.

Name and Address	Principal Business Affiliation	Member Since
Ann M. Anderson 6802 117th Ave NE, Kirkland, WA	VP/Human Resource Kenneth I. Tobey	1998
Harold L. Anderson 6802 117th Ave NE, Kirkland, WA	President Cascade National Insurance Co. and Kenneth I. Tobey, Inc.	1998
Donald L. Morrison 1911 156th Ave SE, Bellevue, WA	Business Consultant Self-employed	1999
Lai L. Morrell 7021-80th Ave SE, Mercer Is, WA	VP/CFO Cascade National Insurance Co.	1998

OFFICERS:

Officers are elected at the annual Board of Directors meeting for a one-year term. Officers on December 31, 1999 were:

Name	Position held
Harold L. Anderson	President
Donald L. Morrison	Secretary
Douglas M. England	VP/Claims
Joseph W. Hischer	VP/Underwriting
Lai. L Morrell	VP/Chief Financial Officer

COMMITTEES:

Due to the size of the Company, there were no board appointed committees as of December 31, 1999.

CORPORATE RECORDS:

The initial **Articles of Incorporation** were adopted by the Board of Directors and filed with the Washington Office of the Insurance Commissioner and the Washington Secretary of State in December 1994. No amendments have been made to the Articles of Incorporation since their adoption.

The **corporate bylaws** were initially adopted and filed in December 1994. The bylaws have not been amended.

The Board of Directors was active throughout the examination period. Meetings were well attended and the minutes were in sufficient detail and substance to demonstrate that the Board of Directors members were actively involved in the administration of the affairs of the Company. All meetings were documented in written form, noting items of discussion and specific actions taken.

AGREEMENTS

The Company is a participant in several agreements. As a member of an insurance company holding system, these have been filed pursuant to RCW 48.31B.025 with the Office of Insurance Commissioner, Company Supervision. As of December 31, 1999, the Company was party to the following agreements:

Cost Sharing Agreements: Since its acquisition from Clarendon Insurance Group, the Company has been sharing its office facilities and employees with Kenneth I Tobey (KIT) an affiliated company through common ownership and a general agency contract. The cost sharing arrangement is set forth in the Administrative Services and Expense Sharing Agreement dated October 1, 1998, by and between Legend Holdings, Inc., Cascade National Insurance Company, and Kenneth I. Tobey, Inc.

All of the employees are employees of KIT. Salaries and payroll benefits are allocated to the Company based on time study of individuals who perform work on behalf of the Company. KIT leases office space and office equipment. The Company's portion of occupancy cost is calculated based on square footage of employees assigned to the Company. For expedient purposes, the Company pays for the lease payment on a photocopier that is also used by KIT to offset the nominal usage of other office equipment. All of the office equipment used by the Company has been fully depreciated. Federal Express, special deliveries and phone costs are charged directly to the Company on a specifically identified basis as are office supplies, stationary, travel and entertainment.

Tax Allocation Agreement: The Company files a consolidated federal income tax return with its parent, Legend Holdings, Inc. The method of allocation between the Company and its parent is subject to written agreement, approved by the Board of Directors. The agreement calls for allocation of taxes based upon separate return calculations with current credit for net losses. Tax sharing is estimated and paid monthly with final settlement made within thirty days after filing of the consolidated return.

On a consolidated basis, the Company and its parent did not have any taxable income in 1999. The amount of net losses carried forward and available to offset future net income subject to federal income taxes are $46,000 from 1999 and $64,000 from 1998.

General Agency Agreements: The Company writes contracts of insurance through insurance agencies. These agencies have the non-exclusive authority to procure, underwrite, process, issue, renew, cancel and service the Company's insurance policies. The agency authority does not extend to the adjustment of claims or the procurement of reinsurance.

Company procedure manuals, rate books, insurance department regulations and other specific instructions provided by the Company are used by these agencies for underwriting, issuance and servicing of insurance policies. The following is a summary of the agencies and their authorized lines of business and territories as of December 31, 1999:

Kenneth I. Tobey, Inc.	Personal & Commercial	AK, CA, OR, WA
Statewide General	Personal	CA
AMCO Insurance Agencies, Inc.	Personal	CA
Cochrane & Company	Commercial	OR, WA
Tower Hill	Mobile Home	MS

The contracts are titled, "Managing General Agency Agreement". The four general agencies producing business for the Company do not meet the definition of a "managing general agent" pursuant to Chapter 48.98 RCW. The word "Managing" should be removed from the agreements. **(see Comments and Recommendations # 2)**

INTERNAL SECURITY

Custodial Agreements:
A securities broker kept the Company securities. This is in non-compliance with the NAIC standard requiring securities to be held in the custody of a bank, trust company, or security depository. There are no custodial agreements that require the minimum standards established by the NAIC concerning the custodian's indemnification of the insurance company for any loss of securities in the custodian's possession.

The Company is instructed to move the securities to a custodian that is permitted under RCW 48.03.010. The Company is also instructed to execute custodial agreements that meet the standards established in RCW 48.13.460, effective July 2000. **(see Instruction # 3)**

Conflict of Interest and Confidentiality Policy: The Company has a conflict of interest agreement and policy that requires the annual completion of a Conflict of Interest Agreement by officers, directors, and key employees. All are required to disclose to the President, Chairman or Board of Directors of the Company, relevant outside interests, memberships, associations, and affiliations. All appropriate persons have complied with this policy. Potential conflict of interest issues and confidential and proprietary information are periodically discussed by and noted in the Company Board of Directors meeting minutes.

The conflict of interest statement and confidentiality policy and Board of Directors review, demonstrate that the Company takes effort to protect the confidentiality of the Company strategy, all records, data and any other information of a private or sensitive nature. No conflicts have been disclosed.

Fidelity Bond and Other Insurance: The Company has no employees. Individuals performing work for the Company exclusively or on a shared-basis are employees of an affiliated company through common ownership and a general agency agreement. Kenneth I. Tobey (KIT) pays all salaries and benefits and all federal and state employment filings are made under KIT's federal employer identification number. Salary and benefits are allocated to the Company from KIT through monthly cost allocations.

Because it has no employees and because the general agency agreements all require the general agent to purchase a fidelity bond and an errors and omissions policy for the benefit of the Company, the Company is not a named insured for fidelity bond protection or errors and omissions protection.

The Company is protected for employee dishonesty through policies purchased by KIT. The fidelity policy purchased by KIT has a $100,000 limit of coverage with a $500 deductible. The NAIC recommended minimum level is $200,000. **(see Instruction # 3)**

The Company is also protected for errors and omissions through policies purchased by the general agents'. The errors and omissions policy purchased by KIT has a $1,000,000 limit of coverage up to an aggregate amount of $3,000,000.

The Company does not own any real property. The Company also does not have any company automobiles and, except for a small amount of personal computers, does not own furniture and equipment. These are owned or leased by KIT. The cost of occupancy is calculated based upon square footage and allocated from KIT who leases the office space. The Company does not need property protection, but KIT carries business personal property coverage of $830,000 with a $500 deductible on the office furniture and equipment it owns.

The Company does not have a director and officer's liability policy. The Corporate Bylaws, Article X, limits and indemnifies officers' and directors' liability in the event of legal claims and proceedings arising from their respective positions. Some directors have additional hold-harmless agreements from the Company for their own personal security. After due consideration of the high premium charges for minimal coverage the board of directors decided to forgo purchasing director and officers liability insurance as of the examination date.

The Company reassessed its position with regards to directors and officer liability coverage and purchased a policy during December 2000 with a $3,000,000 liability limit.

EMPLOYEES' BENEFIT PLANS

Individuals performing work for the Company exclusively or on a shared-basis are employees of Kenneth I. Tobey, Inc., and are eligible to participate in certain KIT sponsored insurance programs and benefit plans on the first of the month following an introductory period. Programs and eligibility vary according to employee status. Benefit costs are allocated to the Company from KIT through monthly cost allocations.

The following benefits are available to the employee: group health insurance (includes a dental plan), group life insurance (includes availability of supplemental life for employees and their spouses), long-term disability insurance and AD&D, profit sharing and retirement.

The cost of the medical coverage for employees and their dependents is shared by the employee (35%) and the employer (65%). Participation in the plan is optional.

Group life insurance and long-term disability insurance and AD&D are provided and paid for by the employer.

A 401(k) Profit Sharing/Retirement Plan is also offered. This is a defined contribution plan in which the employer participates by matching 50% of the employees' before tax contribution to a maximum of 3% of the employee's eligible compensation. Participation is open to employees who are twenty-one years of age and have completed six months of service. Eligible employees may contribute up to 15% of their eligible pay. The employer may also make discretionary profit-sharing contributions that will be allocated among all eligible employees. Employees do not have to make a contribution to share in this allocation. The employee is always 100% vested in their own contributions. Employer contributions, plus any earnings they generate require five years of employment service before they become 100% vested. There are several options for withdrawal and borrowing from the plan.

The plan was modified April 22, 1997 and references an IRS Determination Letter Serial No. D263688a. KIT's Tax Accounting Department could not locate this letter and provide it to examiners for this examination. **(see Instruction #1)**

The usual options for time off from work including vacations, holidays, personal days, and sick leave are also offered. Additional time off from work for special occasions or celebrations are individually granted on an exception basis.

TERRITORY AND PLAN OF OPERATION

The Company is authorized to transact multiple property and casualty lines of business in Alaska, California, Louisiana, Mississippi, Oregon and Washington. During the period under examination, the Company wrote primarily automobile policies in Oregon and Washington and mobile home policies in Mississippi. In more recent years, the Company began writing private passenger automobile policies in California and commercial automobile in Alaska. The Company has been inactive and has not written any premiums in Louisiana.

The following are the Company's historical direct writings:

Direct Premiums Written by State (Schedule T – Premiums)

	1995	1996	1997	1998	1999
Washington	$4,451,945	$19,490,623	$17,318,948	$8,691,180	$6,515,202
Oregon		4,346,504	8,604,091	4,671,039	4,418,129
Mississippi	147,167	1,435,428	1,892,228	1,440,629	1,288,068
California			759,933	111,520	492,081
Alaska					91,274
	$4,599,112	$25,272,555	$28,575,200	$14,914,368	$12,804,754

Direct Premiums Written by Line of Business

	1995	1996	1997	1998	1999
Private Passenger Auto Liability	$3,394,251	$13,413,986	$12,275,368	$6,258,546	$4,623,155
Commercial Auto Liability	165,795	4,558,279	7,635,446	3,953,915	4,019,558
Auto Physical Damage	891,899	5,864,862	6,748,240	3,243,866	2,873,355
Other Liability	-	-	23,918	17,412	619
Homeowners	147,167	1,435,428	1,892,228	1,440,629	1,288,068
	$4,599,112	$25,272,555	$28,575,200	$14,914,368	$12,804,755

The Clarendon Insurance Group (Clarendon) organized the Company in December 1994 in cooperation with Kenneth I. Tobey, an unrelated general insurance agency, to expand its automobile business in Washington, Oregon and California. Authorization was granted separately to Tower Hill, another general insurance agency, to produce mobile home policies in Mississippi on behalf of the Company. Direct premiums substantially increased during its first full year of operation from $4.6 million in 1995 to $28.6 million in 1997. Management curtailed the Company's premium production in 1998 due to market conditions and Clarendon's plan to sell the Company.

After the Company was sold to Legend Holdings, Inc., new management maintained the reduced level of production throughout 1999. Efforts were made to diversify the Company's production source by adding new general insurance agents and expanding territories, states and product offerings. As a result, the Company received its first stand-alone AM Best rating of "B".

REINSURANCE PROGRAM

The Company maintains a general reinsurance program whereby all or a substantial portion of the Company's direct premiums have been ceded to pools of "A" rated authorized reinsurers. As a result of the sale of the Company to Legend Holdings, Inc., Clarendon assumed all retained liabilities on the Company's policies effective prior to July 1, 1998, and all mobile home business produced by Tower Hill. The reinsurance agreements in effect as of January 1, 1998 were confirmed and continued by the Company under new ownership beginning July 1, 1998 with slight modifications.

As the Company expands its production source, premiums written through new general agents are included in the general reinsurance program. Private passenger auto business produced by AMCO Insurance Agency in California is the exception, and this block of business is separately reinsured with Everest Re, an A-rated authorized reinsurer.

A summary of the Company's reinsurance programs as of December 31, 1999 is as follows:

	Retention	Limits	Coverage
General Reinsurance Program			
Private Passenger Auto Quota Share	10%	$0	90%
Commercial Auto Quota Share	15%	$500,000	85%
Commercial Auto Excess of Loss	0%/12.5%	$500,000X $500,000	100%/87.5%*
AMCO Reinsurance Program			
Private Passenger Auto Quota Share (produced by AMCO in California)	10%	$0	90%
Reinsurance Indemnification From Clarendon			
Mobile Home	0%	$0	100%
All auto policies effective prior to July 1, 1998	0%	$0	100%

* In the 4th quarter of 1999, a 12.5% participant to the excess of loss program withdrew and the Company retained the vacated percentage for 3 months. The existing reinsurers subsequently subscribed all of the excess of loss resulting in no excess of loss retention by the Company.

The contracts have the standard insolvency clause wording required by Washington insurance code to minimize the Company risk. The Company does not do business with unauthorized reinsurers.

The Company used two reinsurance brokers during 1999. The "Broker Authorization Contract" was provided and it contained all of the necessary provisions. Written authorization was not evident because signatures were not present on the copy provided by the Company. **(see Instruction # 2)**

INFORMATION SYSTEMS AND ACCOUNTING RECORDS

Cascade National Insurance Company management is sufficiently knowledgeable of Information Systems (IS) issues and provides direction and oversight through the Automation Planning Committee. Systems development, Acquisition and Maintenance Controls were evaluated to gain assurance that programs and systems are designed, tested approved and implemented using appropriate controls. Due to the small size of the Company, there are numerous areas where separation of duties is not possible. In those instances, the Company has stepped up the review and oversight by management.

The IS Department has four (4) officers and employees to operate and maintain its IS system operations and equipment. Rebecca Johnson, Vice President Information Systems, oversees the operations of the system located at the Company's home office.

Operations and Application Controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed and the controls exercised to maintain data security. Adequate procedures and controls are in place for network operations.

During the course of the examination of the premium database, it was noted that commercial general liability coverage was not properly summarized and entered into the database. This caused the database to be out of balance with the account current statement produced by the agencies. The out of balance was immaterial for purposes of this examination. Total written premiums were accurately reported in the annual statement based upon account current statement totals.

Considering the potential for a larger variance, the Company should have more direct oversight of KIT's premium activities. The premium data base needs to have complete policy information and the Company must have the ability to reconcile differences, query and manipulate data within the data base to obtain reporting information to meet the accounting and auditing needs of the Company. **(See Instruction # 1)**

The Company contracted an outside firm to evaluate the database system and better integrate data received from the general agencies. This project was begun during January 2001 and is near completion. (See Subsequent Events)

ACTUARIAL REVIEW

Unpaid loss and loss adjustment expense reserves carried by the Company were $626,738 and $19,220 respectively, as of December 31, 1999.

The casualty actuary employed by the Insurance Commissioner's Office reviewed net loss and loss adjustment expense development data by line, using Schedule P of the Company's Annual Statement for 1999 and amended Annual Statement for 2000. The actuary obtained additional information by interviewing several Company employees. He also reviewed reports prepared for the Company by its consulting actuarial firm, Ernst & Young.

The actuary's best estimates indicate that the Company's booked loss and loss adjustment expense reserves as of December 31, 1999, were not unreasonable. The actuary recommends no adjustments to the liabilities shown in the Company's 1999 Annual Statement.

SUBSEQUENT EVENTS

EDP and Accounting Systems:
Subsequent to the examination date, a decision was made to separate the Company's computer operations from KIT. Beginning in 2001, the Company engaged the services of an outside vendor to run its IS department. The purpose of the engagement is to develop a database system to capture all policy data from various business partners to more completely satisfy the Company's management, financial, regulatory and statistical reporting needs. **(see Instruction #1)**

Management and Control:
The Chief Financial Officer of the Company resigned July 31, 2001 to take a position with another company. The Controller and an acting Chief Financial Officer have assumed the day to day duties of the former CFO. A former CFO of the Company has been retained on a part-time basis for general oversight and special projects. The Company's Vice President of Underwriting position was eliminated in December 2001 as an expense-reduction measure. To fill the need for underwriting support, an Underwriting Manager position reporting to the Vice President of Product Development and Research was added.

Affiliated Non-Insurance Companies Under Common Ownership and Management:
During April 2000, the Company's current President, through another affiliate, purchased 100% of Allied Pacific Adjusting Group. **(see Comments and Recommendations # 1)**

Rapid increase in Premiums Written and Loss Experience:
The State of Washington Office of Insurance Commissioner made the decision to perform additional examination procedures targeting events occurring subsequent to the scheduled examination period through September 30, 2001.

Beginning late in the year 1999 and continuing through March 2001, the Company reported a rapid increase in premiums written. The loss experience began to deteriorate during the second quarter 2000. Loss frequency peaked during the fourth quarter 2000 and first quarter 2001. It was determined that these fluctuations were the result of the increased production from two California general agents.

Examiners reviewed the underwriting procedures and guidelines followed for these two California agents and claim processing procedures of the claim administrator. Additional objectives were to determine the cause of the problem, identify the steps taken by the Company to curtail the adverse experience and identify potential issues with regards to reinsurance and the reduced cash flow caused by reduced premium production.

The examiners chose an integrated approach to analyze claims and the corresponding policies together. A statistical sample using Probability Proportion to Size (PPS) was prepared on claims for the period from January 1, 2000 through June 30, 2001 coming from the business produced by the two California general agents. The sample selected 155 claims on 155 policies. In addition, 20 additional claim files and 11 additional policy files were selected at random off the shelf to perform a completeness test.

Several control weaknesses and insufficient communications between the claim manager and the general agents accounted for all exceptions noted in the sample.

Some exceptions noted:

- Claim data was not in the general agents' policy system or hard copy file for underwriting use on renewals or for determining termination of coverage. This has caused policies to renew with a 20% good driver discount when not warranted, and limited the ability to terminate non-good drivers at renewal. Premiums are not reflective of the actuarial assumptions for which they were calculated. The effect was lower premiums on the insured risk. **(see Instruction #1)**

- Conversely, underwriting information and policy status was not always available to the claim manager when processing a claim. Confirmation of coverage was obtained upon the initial report of loss, however, the general agents often failed to communicate changes in policy status arising from delayed processing. The Examiners noted claims in the sample in which the claim manager paid claims on policies that were not in-force. The Company should, as cost effectively as possible, seek reimbursement on these claims. The Company should also take appropriate action and develop written procedures to improve the flow of needed information between claim processing and underwriting performed by the general agents. **(see Comments and Recommendations # 3)**

- Retail agents not appointed by the Company were given Company forms by the general agents that essentially gave the non-appointed retail agents binding power. Retail agents would give a "proof of insurance card" to prospective policyholders before the application was submitted to the general agent for underwriting. This is in violation of RCW 48.05.310(3). **(see Instruction #4)** However, California law does not require general agents producing for another general agent to be appointed by the Company.

- The general agents have allowed their producing agents the ability to issue policy numbers at the "point of sale". Instances were noted where the applications were subsequently rejected or cancelled when the initial premium payment was returned by the bank for non-sufficient funds. One general agent did not keep a list of those cancellations or rejections and the corresponding policy numbers. One instance was discovered when a claim was filed, where a policy number was used twice. The Company should instruct all general agencies to maintain adequate records to control policy numbers issued and cancellations. **(see Instruction # 1)**

The Company stopped accepting new business from the two California general agencies as of March 31, 2001. Steps were taken at the same time to begin canceling and terminating renewal business guided by California Proposition 103 laws. Action has also been taken to seek appropriate rate increases for the renewal business. The Company also stopped accepting installment premiums from these two agents. Claim processing for the California private passenger auto business has been assigned to a new claims administrator who has already made numerous procedural changes. Indications are that these actions have improved the loss and cash flow experience.

Reinsurance Program Changes:

The Company retained 10% of the private passenger auto business during the year 2000 and 50% of the commercial auto business up to $200,000 per occurrence.

The Company began the year 2001 with a retention of the same 10% of private passenger auto business. However, it picked up another reinsurer for an additional 15% quota share of the commercial auto business, leaving the Company with a 35% participation.

As the California loss experience began to deteriorate, reinsurers began to investigate and one reinsurer cancelled its 65% Quota Share participation in the private passenger auto business effective April 1, 2001. The Company was left with a 75% participation for a three-month period ending July 1, 2001 on the non-California business written during that period. However, reinsurers of California business are required under CA Proposition 103 to accept renewals for a period of three years after termination of the reinsurance contract.

A 45% quota share participation in the private passenger auto business (except California) was placed with another reinsurer effective July 1, 2001, which left the Company with a 30% participation for the remainder of the year.

The reinsurance market became more difficult after September 11, 2001. The Company has secured reinsurance on its commercial auto business, but is still seeking quota share placement on all non-California private passenger auto for the year 2002.

FINANCIAL STATEMENTS

The following statements reflect the financial condition of the Company as of December 31, 1999, as determined by this examination:

Balance Sheet and Statement of Income
As of December 31, 1999

Comparative Balance Sheet and Statement of Income
As of December 31, 1999

Capital and Surplus Account
As of December 31, 1999

Comparative Capital and Surplus Account
Years Ended December 31, 1999

CASCADE NATIONAL INSURANCE COMPANY

BALANCE SHEET and STATEMENT OF INCOME

AS OF DECEMBER 31, 1999

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION	Notes
ASSETS				
Bonds	$5,882,106		$5,882,106	1
Preferred stocks	399,508		399,508	2
Cash and short-term investments	1,420,534		1,420,534	3
Agents' balances or uncollected premiums:				
Premiums in course of collection	(89,189)		(89,189)	4
Premiums booked but deferred and not yet due	132,638		132,638	4
Reinsurance recoverable	902,935		902,935	5
Interest and dividend income due and accrued	84,156		84,156	
Receivable from parent, subsidiaries and affiliates	32,397		32,397	6
Total Assets	$8,765,085		$8,765,085	
LIABILITIES				
Losses	$626,738		$626,738	7
Loss adjustment expenses	19,220		19,220	7
Other expenses (excluding taxes, licenses & fees)	101,274		101,274	
Taxes, licenses & fees (excl. fed. inc. tax)	(12,103)		(12,103)	
Unearned premiums	577,422		577,422	8
Aggregate write-ins for liabilities	87,248		87,248	
Total liabilities	1,399,799		1,399,799	
SURPLUS AND OTHER FUNDS				
Common capital stock	3,000,000		3,000,000	
Gross paid in and contributed surplus	3,500,000		3,500,000	
Unassigned funds (surplus)	865,286		865,286	
Surplus as regards policyholders	7,365,286		7,365,286	
Total liabilities, surplus and other funds	$8,765,085		$8,765,085	
UNDERWRITING INCOME				
Premiums earned	$1,561,671		$1,561,671	
DEDUCTIONS:				
Losses incurred	937,767		937,767	
Loss expenses incurred	206,756		206,756	
Other underwriting expenses incurred	369,620		369,620	
Total underwriting deductions	1,514,143		1,514,143	
Net underwriting gain or (loss)	47,528		47,528	
INVESTMENT INCOME				
Net Investment Income earned	459,539		459,539	
Net realized capital gains or (losses)	23,923		23,923	
Net investment income gain or (loss)	483,462		483,462	
Net income before federal and foreign income taxes	530,990		530,990	
Federal and foreign income taxes incurred	210,938		210,938	
Net income	$320,052		$320,052	

CASCADE NATIONAL INSURANCE COMPANY

COMPARATIVE BALANCE SHEET and STATEMENT OF INCOME
AS OF DECEMBER 31,

	1999	1998
ASSETS		
Bonds	$5,882,106	$6,387,993
Preferred stocks	399,508	
Cash and short-term investments	1,420,534	1,641,203
Agents' balances or uncollected premiums:		
Premiums in course of collection	(89,189)	(179,141)
Premiums booked but deferred and not yet due	132,638	132,273
Reinsurance recoverable	902,935	390,449
Interest and dividend income due and accrued	84,156	89,855
Receivable from parent, subsidiaries and affiliates	32,397	114
Total Assets	$8,765,085	$8,462,746
LIABILITIES		
Losses	$626,738	$123,073
Loss adjustment expenses	19,220	6,766
Other expenses (excluding taxes, licenses & fees)	101,274	49,733
Taxes, licenses & fees (excl. fed. inc. tax)	(12,103)	53,438
Fed. and foreign inc. taxes (excl. def. taxes)		22,872
Unearned premiums	577,422	387,198
Payable to parent, subsidiaries and affiliates		89,790
Aggregate write-ins for liabilities	87,248	34,642
Total liabilities	1,399,799	767,512
SURPLUS AND OTHER FUNDS		
Common capital stock	3,000,000	3,000,000
Gross paid in and contributed surplus	3,500,000	3,500,000
Unassigned funds (surplus)	865,286	1,195,234
Surplus as regards policyholders	7,365,286	7,695,234
Total liabilities, surplus and other funds	$8,765,085	$8,462,746
UNDERWRITING INCOME		
Premiums earned	$1,561,671	$1,849,252
DEDUCTIONS:		
Losses incurred	937,767	1,291,105
Loss expenses incurred	206,756	127,738
Other underwriting expenses incurred	369,620	771,937
Total underwriting deductions	1,514,143	2,190,780
Net underwriting gain or (loss)	47,528	(341,528)
INVESTMENT INCOME		
Net Investment Income earned	459,539	636,120
Net realized capital gains or (losses)	23,923	158,435
Net investment income gain or (loss)	483,462	794,555
Net income before federal and foreign income taxes	530,990	453,027
Federal and foreign income taxes incurred	210,938	(52,137)
Net income	$320,052	$505,164

CASCADE NATIONAL INSURANCE COMPANY

CAPITAL AND SURPLUS ACCOUNT
AS OF DECEMBER 31, 1999

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION	Notes
Surplus as regards policyholders, December 31, previous year	$7,695,234		$7,695,234	
GAINS AND (LOSSES) IN SURPLUS				
Net income	320,052		320,052	
Capital changes				
Surplus adjustments				
Dividends to Stockholders	(650,000)		(650,000)	
Changes in surplus	(329,948)		(329,948)	
Surplus as regards policyholders, December 31, current year	$7,365,286		$7,365,286	

COMPARATIVE CAPITAL AND SURPLUS ACCOUNT
AS OF DECEMBER 31,

	1999	1998	1997	1996	1995
Surplus as regards policyholders, December 31, previous year	$7,695,234	$8,100,070	$7,120,268	$6,700,744	$6,404,779
GAINS AND (LOSSES) IN SURPLUS					
Net income	320,052	505,164	959,802	399,524	275,965
Change in non-admitted assets		40,000	20,000	20,000	20,000
Capital changes					
Surplus adjustments					
Dividends to Stockholders	(650,000)	(950,000)			
Changes in surplus	(329,948)	(404,836)	979,802	419,524	295,965
Surplus as regards policyholders, December 31, current year	$7,365,286	$7,695,234	$8,100,070	$7,120,268	$6,700,744

NOTES AND COMMENTS TO FINANCIAL STATEMENTS

1. **BONDS** in the amount of $5.9 million represents 67.108% of Total Assets and 79.863% of Total Surplus. Bonds are stated at amortized cost. They are investment grade bonds with a NAIC SVO quality rating of 1, and have an average maturity of four years. The Company accrues discounts and amortizes premiums using the scientific method. The Company owned no loan-backed bonds and structured securities at year-end 1999 except for a $500,000 par value, A-rated asset backed security by Chase Credit Card Master Trust. The security bore interest of 6.3%, payable monthly and was disposed of August 16, 2000.

2. **PREFERRED STOCKS** represents 4.558% of Total Assets and 5.424% of Total Surplus. Preferred stocks are reported at amortized cost.

3. **CASH AND SHORT TERM INVESTMENTS** is $1.4 million and 16.207% of Total Assets and 19.287% of Surplus. The balance consists of a negative book balance of ($19,166) in cash and $1,439,700 comprised of NAIC class 1 money market funds invested in US Government securities and a NAIC class 1 commercial paper.

4. **AGENTS BALANCES OR UNCOLLECTED PREMIUMS** are a net $43,449. General Agents pursuant to general agency agreements with the Company produce the premiums. The General Agent collects from the insured and pays the Company for premiums 45 days after the booking date. The General Agents' premium collection procedures and systems automatically cancel policies when premiums are not received from insureds when due. There are no known non-admitted overdue balances.

5. **REINSURANCE RECOVERABLES** and payables are reported as a net receivable from the reinsurance intermediary in the amount of $902,935 which is 10.301% of Total Assets and 12.259% of Surplus. The balance is supported by a cumulative year to date reconciliation prepared by the Company that identifies the ceded premiums and expense, and reinsurance recoverable on loss and loss adjustment expense payments separately. Settlements are based upon this cumulative reconciliation and a billing report prepared by the Company within 30 days after each month end. Positive balances are paid to the intermediary within 60 days after each month end. The intermediary remits any balance shown to be due the Company within 10 days after receipt and verification of the Company's report.

6. **RECEIVABLE FROM PARENT, SUBSIDIARIES AND AFFILIATES** is a net receivable from two affiliated companies in the amount of $32,397 or 0.370% of Total Assets. Expense allocation is subject to a Board of Directors approved agreement providing for the allocation of expenses in a consistent and equitable manner. Balances covered by this agreement are reported to each other within 10 days after the end of each calendar month and are remitted within 15 days of the receipt of the report.

   FEDERAL INCOME TAX RECOVERABLE/PAYABLE is included in the intercompany receivable/payable annual statement line. The Company files a consolidated return with its parent, Legend Holdings, Inc. The method of allocation between the companies is subject to an agreement approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses.

   The Company records its portion of the estimated tax liability for each month through the inter-company receivable from/payable to account. These balances are settled within fifteen business days after the affiliated companies have closed the books for the month. The final inter-company tax balances are settled annually in the filing quarter when the final liability is determined.

7. **UNPAID LOSSES AND UNPAID LOSS ADJUSTMENT EXPENSES** are respectively reported as $626,738 or 7.150% and $19,220 or 0.219% of Total Assets and 8.509% and 0.261% of Surplus as of December 31, 1999. The OIC Actuary's best estimates indicate that the reported reserves were not unreasonable.

8. **UNEARNED PREMIUMS** are 6.588% of Total Assets and 7.840% of Surplus.

ACKNOWLEDGMENT

The cooperation extended to the examiners by the officers and employees of the Company during the course of this examination is hereby acknowledged.

In addition to Larry A. Omdal, Examiner in Charge, Keith Henderson, Insurance Examiner, Constantine Arustamian, Insurance Examiner, John Jacobson, Insurance Examiner and EDP Specialist, Michael Jordan, Insurance Examiner and Reinsurance Specialist, Lee Barclay, FCAS, MAAA, Senior Actuary and James Antush, Actuarial Analyst 2, all from the Office of Insurance Commissioner, State of Washington, participated in the examination and preparation of this report.

State of Washington)
) ss
County of King)

Larry A. Omdal, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

____

Larry A. Omdal
Examiner in Charge

Subscribed and sworn to before me on this 29th day of March, 2002.

____

Notary Public in and for the

State of Washington,

residing at ___________________________